Investment Grade Credit: 2023 Outlook

JPM Corporate Bond Research Enhanced Index (ESG) ETFs*

Corporate fundamentals: Entering 2023 in a position of strength

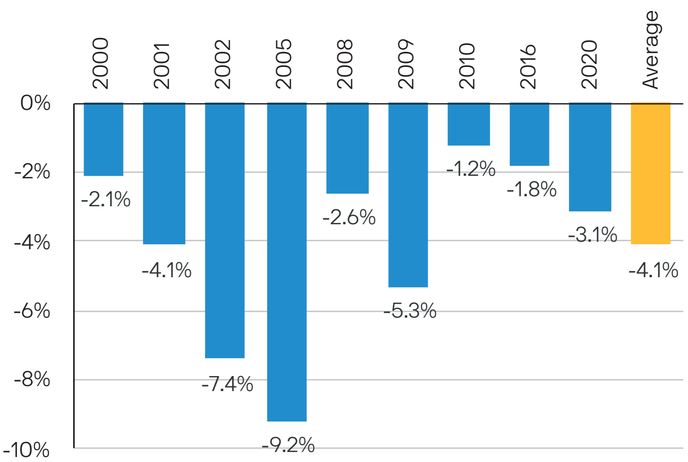
Early 2022 saw levels of revenue growth that were high to the point of being unsustainable. In both Europe and the US, earnings returned to a more moderate run rate of 9% and 8% year-on-year (y/y) respectively in Q3 2022 (source: J.P. Morgan AM as of 30 September 2022). Positively, the overall growth rate is still above long-run averages. Despite an inflationary environment, margins have remained stable in Europe at 13%, triggering further improvements with net leverage falling to 1.7x, below the pre-Covid level of 2.1x. Operating margins for US Investment Grade (IG) declined slightly to 14% and net leverage has risen slightly to 1.9x but remains below its pre-Covid high of 2.2x. On a sector-by-sector basis, the number of industries where the fundamental outlook is negative is exceeding those with a positive view for the first time since before Covid, suggesting some caution is warranted as we move into the new year. Despite this, we see opportunity in a number of sectors and have conviction in high quality names.

Looking forward, IG corporate health remains in a relatively robust position. Historically in the later part of the cycle, corporate debt growth begins to rise sharply, creating challenges for credit investors as they attempt to navigate the downturn. Since the Covid pandemic, company managers have continued to adopt a conservative approach to managing balance sheets and have subsequently limited overall debt growth. Regardless of the economic reality of 2023, IG corporates have entered this year in a position of strength with some of the lowest gross debt growth since the global financial crisis.

Dodging Downgrades

During recessionary periods, investors need to be mindful of potential "fallen angels" – issuers that are downgraded from investment grade to high yield following a deterioration in their credit fundamentals. Since 2000, IG credit has undergone nine credit bear markets. Historically during credit bear markets, on average 4% of the US investment grade universe has been downgraded to high yield. However, not all downgrade cycles are made equally. During 2020, the level of downgrades has been relatively muted as loose monetary policy and generous fiscal programmes have helped mitigate the impact on credit markets. In the coming downturn, the total number of downgrades could look closer to the longrun average of 4% as stubbornly high inflation prevents policymakers from significantly easing financial conditions. However, strong corporate balance sheets are likely to make IG credit more resilient to an economic downturn despite limited policy support.

% of US IG Index Downgraded to High Yield During Credit Bear Markets



Source: J.P. Morgan Asset Management, Barclays

A technical glimmer of hope

A theme with potential to continue into Q1 2023 is the return of inflows to the asset class, as some of the highest all-in yields since the summer of 2009 offer an attractive entry point. Over the course of 2022, US IG has experienced total outflows amounting to $157bn over the year (source: EPFR as of 31st December 2022). Since 2010, there has been significant relationship between retail flows and returns. When returns turn negative outflows typically follow but when returns begin to look positive again investors typically come back to the asset class. However, as of mid-December 2022, inflows have shown some signs of bucking this historic trend as the attractive all-in yields have offered investors a more interesting entry point into the asset class.

J.P.Morgan
ASSET MANAGEMENT

If this trend continues, it should offer a more stable technical backdrop for IG corporates in 2023.

More spread widening to come?

While all-in yields do look historically attractive, investors need to be mindful of volatility in spreads as we approach the later part of the economic cycle. Once the US Treasury curve inverts (typically measured by the 2s10s spread), corporate spreads can trade within a wide range, but they typically do not peak until the economy is in recession. Currently, spreads in the US IG market are pricing in a relatively low probability of recession suggesting that as growth slows, spreads may widen further from here, but it may take some time for markets to adjust to the economic reality.

In this environment, opportunities might also lie in taking advantage of the current shape of the yield curve to implement carry-and-roll trades. In Europe, the 10 year and shorter portion of the euro corporate bond market look attractive. Meanwhile in US IG, the 5-10 year part of the curve screens particularly well. Moving into 2023, we think there are opportunities to be found in IG corporates.

Enhance your core: JPM Corporate Bond Research Enhanced Index (ESG) ETFs

Our JPM Corporate Bond Research Enhanced Index (ESG) ETFs* (CREIs) focus on efficiently replicating the risk profile of the credit investment universe whilst adding value predominantly through security selection. By systematically incorporating our proprietary security rankings produced by our credit research analysts, we aim to tilt the portfolios towards issuers we believe will outperform away from those we think will underperform, particularly issuers at risk of being downgraded. This approach can help investors navigate these challenging markets by avoiding the losers rather than just picking the winners.

The CREI range includes three exposures investing in EUR, EUR 1-5yr and USD Corporate Bonds*. Our credit scoring approach incorporates financially material ESG considerations, environmental, social and governance (ESG) considerations into its assessment of individual issuers. The JPM Corporate Bond Research Enhanced Index (ESG) ETFs* are classified as Article 8 under the SFDR regulation, due to the exclusion of controversial industries and integrating financially material ESG factors throughout the investment process.

JPMAM defines ESG integration as the systematic inclusion of financially material ESG factors amongst other factors in our investment decisions with the goals of managing risk and improving long-term returns. ESG integration does not change a strategy's investment objective, exclude specific types of companies or constrain a strategy's investable universe.

* FOR BELGIUM ONLY Please note the acc share class of the ETF marked with an asterisk (*) in this page are not registered in Belgium and can only be accessible for professional clients. Please contact your J.P. Morgan Asset Management representative for further information. The offering of shares has not been and will not be notified to the Belgian Financial Services and Markets Authority (Autoriteit voor Financiële Diensten en Markten/ Autorité des Services et Marchés Financiers) nor has this document been, nor will it be, approved by the Financial Services and Markets Authority. This document may be distributed in Belgium only to such investors for their personal use and exclusively for the purposes of this offering of shares. Accordingly, this document may not be used for any other purpose nor passed on to any other investor in Belgium.

LV–JPM54072 | 01/23 | 09wi231901132113